

Washington University Law Review

Volume 92 | Issue 1

2014

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Recommended Citation

Mark C. Westenberger, *A Path to "Inure" Peace: Consolidating the Perplexities of the Private Inurement and Private Benefit Doctrines*, 92 WASH. U. L. REV. 227 (2014).

Available at: https://openscholarship.wustl.edu/law_lawreview/vol92/iss1/10

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A PATH TO “INURE” PEACE: CONSOLIDATING THE PERPLEXITIES OF THE PRIVATE INUREMENT AND PRIVATE BENEFIT DOCTRINES

INTRODUCTION

The preferential tax treatment of charities is an ancient tradition.¹ This treatment was originally grounded in divine, but also procedural, principles.² During antiquity, revenue agents felt that the gods who owned religious institutions were beyond the agents’ jurisdiction.³

Over time, the justification for the preferential tax treatment of charities⁴ has generally shifted to corporeal grounds.⁵ This shift began in earnest with the Elizabethan Statute of Charitable Uses in 1601.⁶ The Statute’s preamble is widely considered to have established the foundations of modern charity law by providing the first authoritative definition of charitable purposes.⁷ The Statute’s enumerated purposes, which included relief of the poor, the promotion of education, and aid for various public works,⁸ were not considered to be exclusive, but were instead intended to form a broad constellation of philanthropy.⁹ The

1. “And Joseph made it a law over the land of Egypt unto this day, that Pharaoh should have the fifth part; except the land of the priests only, which became not Pharaoh’s.” *Genesis* 47:26 (King James) (internal citations omitted).

2. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 294 (4th ed. 2010).

3. *Id.* See also Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 511 (2010).

4. A matter of nomenclature: this Note will deal exclusively with organizations exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code. Throughout the Note, I will refer to these organizations as “charities” and “charitable organizations.” The Supreme Court has held that the common law of charitable trusts must be read into section 501(c)(3) of the Code, and therefore all organizations exempt under section 501(c)(3) must be “charitable.” Thus, although section 501(c)(3) enumerates several purposes for which a tax-exempt organization may be formed (including religious, charitable, or educational), all organizations exempt under section 501(c)(3) may be broadly called “charities.” See *Bob Jones Univ. v. United States*, 461 U.S. 574, 585–92 (1983).

5. See *infra* note 15 for a discussion of several theoretical justifications for the charitable exemption.

6. 1601, 43 Eliz., c. 4 (Eng.).

7. John P. Persons, John J. Osborn, Jr. & Charles F. Feldman, *Criteria for Exemption Under Section 501(c)(3)*, in IV RESEARCH PAPERS: TAXES 1909, 1912–13 (1977).

8. Professor Jill Horwitz has examined the remarkable similarities between the enumerated charitable purposes in the Preamble to the Elizabeth Statute of Charitable Uses and the purposes merited as providing a path to salvation in William Landland’s fourteenth century poem, *The Vision of Piers the Plowman*. Jill Horwitz, *Nonprofits and Narrative: Piers Plowman, Anthony Trollope, and Charities Law*, 2009 MICH. ST. L. REV. 989, 995–1000. See also WILLIAM LANGLAND, *THE VISION OF PIERS THE PLOWMAN* 113–23 (W.W. Skeat trans., 1922).

9. Persons, Osborn & Feldman, *supra* note 7, at 1913. See also Chauncey Belknap, *The Federal*

underlying theme of the enumerated purposes, and the Statute itself, was that charities should serve a public benefit.¹⁰

When Congress enacted the Tariff Act of 1894 that first exempted charities from federal taxation,¹¹ the influence of the English law of charitable trusts remained.¹² So, too, did a fundamental tenet: “[C]harities were to be given preferential treatment because they provide a benefit to society.”¹³ Moreover, the Supreme Court has held that “underlying all relevant parts of the [Internal Revenue] Code” are “common-law standards of charity” that require charities to “serve a public purpose.”¹⁴

Hence, the traditional rationale¹⁵ for the charitable tax exemption is

Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy, in IV RESEARCH PAPERS: TAXES 2025, 2027 (1977) (stating that “the courts interpreted the favored uses broadly as including religion, education, and miscellaneous public uses”).

10. Persons, Osborn & Feldman, *supra* note 7, at 1913. See also Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2448–51 (2005).

11. The Tariff Act of 1894 provided tax exemption for “corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.” Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894).

12. “The draftsmen of the 1894 income tax law, which included the first charitable exemption provision, relied heavily on English concepts of taxation; and the list of exempt organizations appears to have been patterned upon English income tax statutes.” *Bob Jones Univ. v. United States*, 461 U.S. 574, 589 n.13 (1983).

13. *Id.* at 589.

14. *Id.* at 586.

15. In addition to the traditional rationale, there are several and sundry academic theories explaining the existence of the charitable exemption. First, there is the income measurement theory, which argues that because the charitable sector doesn’t generally produce profits in the same way as the for-profit sector, it is difficult to measure a charity’s net income. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 307–16 (1976). Second, there is the capital subsidy theory, which argues that charities should qualify for exemption when they are the more efficient producers of goods and services (i.e., when there is contract failure), and they are undercapitalized. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 86 (1981). See also Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981). Third, there is the donative theory, which argues that charitable organizations should receive exemption based on their ability to generate substantial donative support from the public. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 389–405 (1991). Fourth, there is the altruism theory, which argues that the decision of a charity’s founders to forgo profits is an appropriate justification in itself for extending exemption to the charity. Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 628–30 (1990). Fifth, there is the risk compensation theory, which argues that exemption is a way to compensate charities for the inherent financial risks that accompany the provision of public goods and services. Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 439–61 (1998). Finally, there is the access theory, which argues that in order to qualify for exemption, a charity should either provide goods and services to previously underserved communities, or provide goods and services to the general public that would otherwise be unavailable. John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 WASH. U. L.Q. 343, 363–74 (2004).

anchored in this mutually supportive relationship¹⁶ between the government and charitable organizations.¹⁷ As such, the Supreme Court has labeled tax exemptions a form of subsidy¹⁸ justified by the public benefit provided by charities—although the Court was cautious to state that exemptions are not “in all respects identical” to cash subsidies.¹⁹ But, still, the Court has held that these subsidies are conditioned on the fact that the charity’s activities are not “conducted for private gain.”²⁰

This prohibition against private gain, that is, a prohibition against distributing net earnings to the individuals in control of an organization, is the defining feature of a charitable organization.²¹ Professor Henry Hansmann labeled this prohibition the “nondistribution constraint.”²² Hansmann argued that the prohibition does not preclude a charity from making profits—in fact, many do make substantial profits—but it does require the charity to use those profits to further its charitable mission.²³ The nondistribution constraint and the *sine qua non* that a charity must serve a public, rather than a private, purpose form the nucleus of the private inurement²⁴ and private benefit doctrines,²⁵ which will be the focus of this Note.

The private inurement and private benefit doctrines, along with the related intermediate sanctions regime²⁶ under section 4958 of the Internal Revenue Code, are the key enforcement tools that the Internal Revenue Service and the courts may use to regulate financial abuses by charities and ensure that charities are being operated for the public’s benefit—not the benefit of private individuals.²⁷ Broadly speaking, the private inurement and private benefit doctrines allow the Service to revoke a charity’s tax-exempt status if the charity is no longer being operated

16. See *IHC Health Plans, Inc. v. Comm’r*, 325 F.3d 1188, 1195 (10th Cir. 2003) (“The public-benefit requirement highlights the *quid pro quo* nature of tax exemptions: the public is willing to relieve an organization from the burden of taxation in exchange for the public benefit it provides.”).

17. *Bob Jones Univ.*, 461 U.S. at 590–91. See also Belknap, *supra* note 9, at 2029; *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1620 (1992); Fleischer, *supra* note 3, at 518; Atkinson, *supra* note 15, at 605–10; Hall & Colombo, *supra* note 15, at 345.

18. *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983).

19. *Id.* at n.5.

20. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924).

21. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 15, at 501; Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2018 (2007); Dana Brakman Reiser, *Charity Law’s Essentials*, 86 NOTRE DAME L. REV. 1, 7–8 (2011).

22. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 15, at 838.

23. *Id.*

24. See *infra* Part II.A.

25. See *infra* Part II.B.

26. See *infra* Part II.C.

27. See FISHMAN & SCHWARZ, *supra* note 2, at 445–71.

exclusively for charitable purposes.²⁸ The intermediate sanctions regime allows the Service to impose excise tax sanctions, usually in lieu of revocation of the charity's tax-exempt status, when a charity provides excessive economic benefits to certain "insiders."²⁹

The private inurement and private benefit doctrines generally differ in two respects.³⁰ First, although an incidental amount of private benefit usually will not jeopardize a charity's tax-exempt status, the ban on private inurement is statutorily absolute.³¹ Second, although the private benefit doctrine may be applied against any person receiving an inappropriate benefit not afforded to the general public, the ban on private inurement applies only to persons commonly referred to as "insiders." "Insiders" are generally considered to be those exercising a substantial level of control over the charity, such as directors, officers, or key employees.³²

The charitable sector is an important part of the U.S. economy.³³ A 2009 Congressional report estimated that charities employ more than seven percent of the U.S. workforce.³⁴ That same report found that in 2009, charities had \$1.4 trillion in revenues and held \$2.6 trillion in assets.³⁵ Therefore, because charities employ such a large segment of the U.S. workforce, generate such substantial revenues, and hold such sizeable assets, it is critical that the Service and the courts have a functional and effective enforcement mechanism to protect the public's interests.

This Note will proceed in five parts. Part I will briefly outline the exemption of charities under section 501(c)(3) of the Internal Revenue Code. Part II will examine the law and ideology of the private inurement and private benefit doctrines, as well as that of the related intermediate sanctions regime. Part III will utilize two cases, *United Cancer Council v.*

28. *Id.* For more on the private inurement doctrine, see *infra* Part II.A. For more on the private benefit doctrine, see *infra* Part II.B.

29. *Id.* "Insiders" are called "disqualified persons" under the intermediate sanctions regime, and generally refer to persons exercising a certain degree of control or influence over the organization. For more on the intermediate sanctions regime and disqualified persons, see *infra* Part II.C.

30. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, 537 (10th ed. 2011).

31. I write that the ban on private inurement is "statutorily" absolute because the Code states that no amount of private inurement is tolerated. However, it is unclear whether, in practice, the Service and the courts tolerate an incidental amount of private inurement. See *id.* at 531–33.

32. *Id.* at 537. See also Oliver A. Houck, *With Charity for All*, 93 YALE L.J. 1415, 1427 (1984) ("The trigger for [the private inurement provision] is an 'insider,' one who by virtue of his position can control or influence an organization's action.").

33. See generally FISHMAN & SCHWARZ, *supra* note 2, at 12–19.

34. MOLLY F. SHERLOCK & JANE G. GRAVELLE, AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR 4 (Congressional Research Service, Nov. 17, 2009).

35. *Id.* at 9–11.

*Commissioner*³⁶ and *Capital Gymnastics Booster Club, Inc. v. Commissioner*,³⁷ as case studies to evaluate the application of and distinctions between the two doctrines. In Part IV, I will argue that that these two doctrines should be consolidated into one doctrine for three reasons. First, the private inurement doctrine is murky and subject to inconsistent application. Second, the private inurement doctrine is redundant, because it has largely been supplanted by the intermediate sanctions regime and may be subsumed within the private benefit doctrine. Third, the consolidation of the two doctrines will result in judicial economy. Part V will conclude.

I. THE CHARITABLE EXEMPTION: I.R.C. § 501(c)(3)

Section 501(c)(3) of the Internal Revenue Code imposes three requirements on a charity seeking exemption. First, the charity must be organized and operated exclusively for tax-exempt purposes.³⁸ Second, no part of the net earnings of the charity may inure to the benefit of any shareholder or individual.³⁹ Third, the charity must refrain completely from engaging in any political campaigns or activities and may not engage in more than an insubstantial amount of lobbying.⁴⁰

Expounding on the Code’s requirements, the Treasury Regulations set out organizational and operational tests that charities must meet for exemption.⁴¹ A charity meets the organizational test primarily by filing articles of incorporation that satisfy two requirements. First, the articles must limit the purposes of the charity to one or more exempt purposes.⁴² Second, the articles must not “expressly empower” the charity to engage in more than an insubstantial amount of non-exempt activities.⁴³

The operational test, which requires that a charity engage “primarily in

36. 165 F.3d 1173 (7th Cir. 1999).

37. T.C.M. (RIA) 2013–193.

38. Among the enumerated purposes of I.R.C. § 501(c)(3) are: “religious, charitable, scientific, testing for public safety, literary, or educational.” I.R.C. § 501(c)(3) (2010).

39. This provision is the prohibition against private inurement. The prohibition generally prohibits any insider of the charity—such as a director, officer, or significant donor—from siphoning off any part of the charity’s assets or earnings. *Id.*

40. The Service has not provided a specific number to define “substantial,” but charitable organizations seeking more definitive guidelines on lobbying may file what is commonly referred to as a 501(h) election. This is a one-page form that the organization may elect to file with the IRS regarding its lobbying activities, and in return the organization effectively receives a safe harbor provision under which a generous amount of lobbying is allowed. I.R.C. § 501(h) (2010).

41. Treas. Reg. § 1.501(c)(3)-1(a)–(c) (2012).

42. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(a) (2012). The exempt purposes set forth in Treasury Reg. § 1.501(c)(3)-1(d)(1) essentially mirror those of section 501(c)(3) of the Code and include religious, charitable, scientific, etc. Treas. Reg. § 1.501(c)(3)-1(d)(1) (2012).

43. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(B) (2012).

activities which accomplish one or more . . . exempt purposes,” generally mirrors the requirements of section 501(c)(3) of the Code, but additionally offers a few interesting modifications.⁴⁴ First, in determining whether a charity is operated “exclusively” for exempt purposes, the Treasury Regulations interpret “exclusively” as “primarily.”⁴⁵ Second, the Treasury Regulations denote charities that violate the ban on political activities or the limitations on lobbying as “action organizations.”⁴⁶ A charity is at risk of becoming an action organization if it engages in too much lobbying, any amount of direct political campaigning, or adopts a direct political purpose.⁴⁷

Furthermore, the Treasury Regulations define the term “charitable.”⁴⁸ Indeed, the regulations state that the term should be construed in its “generally accepted legal sense” and is therefore broad and not limited by the specific enumerated purposes in section 501(c)(3) and the regulations.⁴⁹ The Joint Committee on Taxation has articulated the legal definition of “charity” as being “best understood as including activities that are intended to benefit the general welfare or public interest” and has stated that this definition “can be construed broadly or narrowly . . . to reflect changing notions of the public interest.”⁵⁰

Moreover, the Supreme Court has held that the common law standards of charity underlie section 501(c)(3) of the Code.⁵¹ Accordingly, any charity seeking exemption must provide a public benefit and not violate established public policy.⁵² Likewise, the charitable purposes first enumerated in the Elizabethan Statute of Charitable Uses in 1601 and

44. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2012).

45. *Id.*

46. Treas. Reg. § 1.501(c)(3)-1(c)(3) (2012).

47. Treas. Reg. § 1.501(c)(3)-1(c)(3)(i)-(iv) (2012).

48. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2012).

49. *Id.* See also Bittker & Rahdert, *supra* note 15, at 330-33; Houck, *supra* note 32, at 1422-23 (comparing the enumerated purposes in the Statute of Charitable Uses and the Treasury Regulations and noting that “[f]rom 1601 to 1982, few changes can be observed in the concept or the language of charity”). Professor Thomas Kelley has argued that when the Treasury promulgated the 1959 regulations, which adopted the “generally accepted legal sense” meaning of charity, it departed from what Congress had intended. Kelley, citing the work of Bruce Hopkins, has argued that prior to 1959, the statutory construction of the Code, the legislative history, and the Treasury Regulations “consistently defined charity as ‘relief of the poor.’” Kelley has credited Congress’s silence in the wake of this change as resulting in a broad, and arguably vague, modern definition of charity. Kelley, *supra* note 10, at 2470-72.

50. JOINT COMM. ON TAXATION, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 62 (Apr. 19, 2005).

51. *Bob Jones Univ. v. United States*, 461 U.S. 574, 586 (1983).

52. *Id.*

developed in the common law over centuries may be read into the Code.⁵³ These purposes include relief of the poor, the advancement of education, and the advancement of religion, but may also include purposes not specifically enumerated in a statute that nonetheless benefit an indefinite number of persons in the community.⁵⁴ Thus, the definition of “charity” is not static—rather, it is elastic, malleable, and adapting with the times.

II. PRIVATE INUREMENT, PRIVATE BENEFIT & THE INTERMEDIATE SANCTIONS REGIME

In this Part, I will discuss the private inurement and private benefit doctrines, as well as the related intermediate sanctions regime. These enforcement tools serve to enforce the nondistribution constraint, prevent a charity from dispensing improper economic benefits, and guarantee that the common law requirement that a charity serve a public purpose is met. I will first discuss the private inurement doctrine, then explain the private benefit doctrine, and conclude with the intermediate sanctions regime.

A. Private Inurement

Since 1909⁵⁵ each version of the Internal Revenue Code exempting charities from taxation has included a ban on private inurement.⁵⁶ Regarding the prohibition’s legislative beginnings, Professor Darryll Jones has written that the measure was meant to prevent any “element of personal gain.”⁵⁷ Further, exemption would be granted only to charities “in which no man receives a scintilla of individual profit.”⁵⁸

Today, section 501(c)(3) of the Internal Revenue Code exempts a charitable organization from taxation provided that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual.”⁵⁹ This statutory prohibition on private⁶⁰ inurement continues the long-standing public policy that a charity should

53. *Id.* at 586–92.

54. *Id.* See also *Jackson v. Phillips*, 96 Mass. 539, 556 (1867).

55. Corporation Excise Tax Act of 1909, ch. 6, sec. 38, 36 Stat. 112 (1909).

56. JOINT COMMITTEE ON TAXATION, *supra* note 50, at 54.

57. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 591 (2000) (quoting 44 CONG. REC. S4151 (1909) (statement of Sen. Bacon)).

58. *Id.*

59. I.R.C. § 501(c)(3) (2010).

60. The word “private” in the context of private inurement has been defined by one court as “the antonym of ‘public’; a private stockholder, as distinguished from the general public, the supposed beneficiary of the benevolent activities of an institution devoted exclusively to public betterment.” *Kemper Military School v. Crutchley*, 274 F. 125, 127 (W.D. Mo. 1921).

benefit the public at large, not private individuals.⁶¹ Courts have held that the prohibition on private inurement is absolute.⁶² In fact, even small benefits that a charitable organization considers to be trivial may constitute private inurement and result in the revocation of the organization's exemption.⁶³

Thus, because even a small amount of private inurement may result in revocation of the charity's exemption, each part of the statute must be read closely. "Net earnings" is defined broadly and is generally considered to include any asset of the charity.⁶⁴ The Treasury Regulations define the terms "private shareholder or individual" to refer to persons "having a personal and private interest in the activities of the organization."⁶⁵ Similarly, "private shareholder[s] or individual[s]" generally have been considered by the courts to be founders or controlling members who are considered "insiders"—the equivalent of owners or managers—and are in control of the charity's affairs.⁶⁶ But because the test is "functional" and "looks to reality of control" rather than a person's formal role within the charity, "insiders" are not necessarily limited to members of the charity's board of directors or employees.⁶⁷ As a matter of fact, the Service has made efforts to define insiders broadly.⁶⁸

Likewise, determining when an asset "inures to the benefit" of an insider is not always clear, but the Service and the courts have provided

61. *Church of Scientology of Cal. v. Comm'r*, 823 F.2d 1310, 1315–16 (9th Cir. 1987).

62. *Id.* at 1316.

63. In *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153–54 (E.D. Wash. 1963), the court revoked a social club's charitable exemption because the club served refreshments to its members. The court held that, "although the amounts were not large, [it] must hold that the organization was not operated exclusively for . . . charitable . . . purposes and that part of the earnings of the organization did inure to the benefit of private individuals." *Id.* at 154.

64. See *Church of Scientology of Cal.*, 823 F.2d at 1316 (noting that "[c]ourts have construed broadly the term 'net earnings'"); *People of God Cmty. v. Comm'r*, 75 T.C. 127, 133 (1980) (holding that "paying over a portion of gross earnings to those vested with the control of a charitable organization constitutes private inurement as well"); *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974) ("The phrase 'net earnings', [sic] as used in § 501(c)(3), may include 'more than the term net profits as shown by the books of the organization or than the difference between the gross receipts and disbursements in dollars.'") (quoting *Nw. Mun. Ass'n v. United States*, 99 F.2d 460, 463 (8th Cir. 1938)).

65. Treas. Reg. § 1.501(a)-1(c) (2012).

66. See *People of God Cmty.*, 75 T.C. at 133 ("[S]ection 501(c)(3) denies exempt status to an organization whose founders or controlling members have a personal stake in that organization's receipts."). See also *United Cancer Council v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999) ("A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager.").

67. *United Cancer Council*, 165 F.3d at 1176.

68. See I.R.S. Gen. Couns. Mem. 39,862 at 7 (Nov. 22, 1991) ("[T]his Office [has] stated that all persons performing services for an organization have a personal and private interest in it, and therefore possess the requisite relationship to find inurement.").

some guidance. Generally, private inurement may be found where an insider with financial control over a charitable organization is using the organization's assets for the insider's personal gain.⁶⁹ For example, inurement will result where an insider is overcompensated by a charity for services or property, or the insider underpays the charity for services or property that the charity has provided to the insider.⁷⁰ Yet, the prohibition against private inurement does not preclude a charity from paying its employees a reasonable salary.⁷¹ In determining whether an employee's compensation violates the prohibition on private inurement, the Service usually will apply a facts and circumstances test in order to examine the compensation package as a whole.⁷² As part of its analysis, the Service will consider three factors: first, whether the compensation package is not simply a way to distribute profits to insiders; second, whether the compensation is the result of arm's length bargaining; and third, whether the salary is reasonable when compared to individuals performing analogous functions at similar organizations.⁷³

B. Private Benefit

The private benefit doctrine is generally considered to be the progeny of the common law rule that a charitable trust must serve an unselfish purpose and benefit a “sufficiently large and indefinite charitable class rather than specific private individuals.”⁷⁴ Set out in the Treasury Regulations, the private benefit doctrine requires a charitable organization to serve “a public rather than a private interest” and “establish that it is not

69. See I.R.S. Gen. Couns. Mem. 38,459 at 7 (July 31, 1980) (“Inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes.”). See also I.R.S. Gen. Couns. Mem. 39,862 at 7 (Nov. 21, 1991) (“A charitable organization is viewed under the common law and the Internal Revenue Code as a trust whose assets must irrevocably be dedicated to achieving charitable purposes. The inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use.”).

70. John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1067–68 (2006).

71. *World Family Corp. v. Comm'r*, 81 T.C. 958, 969 (1983) (“The law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts.”). See also *Church of Scientology of Cal. v. Comm'r*, 823 F.2d 1310, 1316 (9th Cir. 1987) (“Payment of reasonable salaries . . . does not constitute inurement. However, payment of excessive salaries will result in a finding of inurement. Inurement can also result from distributions other than the payment of excessive salaries. Unaccounted for diversions of . . . resources by one who has complete and unfettered control can constitute inurement.”) (internal citations omitted).

72. I.R.S. Gen. Couns. Mem. 39,670 (June 17, 1987).

73. *Id.* at 4–5.

74. FISHMAN & SCHWARZ, *supra* note 2, at 459 (citing RESTATEMENT (THIRD) TRUSTS § 28 (2003)).

organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”⁷⁵ Thus, because a charity is not operating exclusively for exempt purposes if it is benefiting private individuals, the private benefit doctrine can be read into the statutory language of section 501(c)(3). Put differently, the private benefit doctrine in essence reiterates the statutory requirements of 501(c)(3).⁷⁶

While the private inurement doctrine applies only to “insiders,” the private benefit doctrine “denies exemption when persons other than insiders receive more than an incidental ‘private benefit.’”⁷⁷ A private benefit may include an “‘advantage; profit; fruit; privilege; gain; [or] interest.’”⁷⁸ Also, where any amount of private inurement can be fatal, an “‘incidental’ amount of private benefit, viewed in a qualitative and quantitative sense, is not fatal.”⁷⁹ Still, while an incidental benefit to a private individual may not jeopardize a charitable organization’s tax-exempt status—provided the benefit is conferred in connection with an activity conducted in the pursuit of exempt purposes—if the activity constitutes more than an “insubstantial” part of an organization’s activities, the Service may not view the organization as operating “exclusively” for exempt purposes.⁸⁰

What is “insubstantial”? The courts and the Service have provided some guidance. The Tax Court has held that activities constituting less than ten percent of a charity’s total activities may be considered insubstantial.⁸¹ However, because the Tax Court applied a facts and circumstances test, this decision provides limited guidance to charities.⁸² The Service defines insubstantial as “incidental” in both qualitative and quantitative senses.⁸³ To be incidental in the qualitative sense, “the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved

75. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2012).

76. FISHMAN & SCHWARZ, *supra* note 2, at 459.

77. FISHMAN & SCHWARZ, *supra* note 2, at 458.

78. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1065–66 (1989) (alteration in original) (quoting *Retired Teachers Legal Fund v. Comm’r*, 78 T.C. 280, 286 (1982)).

79. FISHMAN & SCHWARZ, *supra* note 2, at 458–59.

80. *See World Family Corp. v. Comm’r*, 81 T.C. 958 (1983). *See also Am. Campaign Acad.*, 92 T.C. at 1066 (“Occasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits.”).

81. *World Family Corp.*, 81 T.C. at 966–67.

82. *Id.*

83. *See I.R.S. Gen. Couns. Mem.* 37,789 at 3 (Dec. 18, 1978).

without necessarily benefiting certain private individuals.”⁸⁴ The quantitative analysis measures any private benefit against the public benefit and requires that any private benefit be insubstantial.⁸⁵

C. Intermediate Sanctions

Recognizing the limitations of the private inurement doctrine,⁸⁶ in 1996 Congress created an intermediate sanctions regime.⁸⁷ They did so largely for two reasons: first, to provide the Service with greater flexibility when seeking corrective action where individuals have received an “excess benefit”; second, to provide an imposable rule.⁸⁸ The intermediate sanctions regime, found in Section 4958 of the Code, allows the Service to sanction the person or persons who are responsible for providing the private inurement—as well as those who have received it—without revoking a charity’s exemption, which is considered a draconian measure and is rarely deployed.⁸⁹ While section 4958 sanctions are ordinarily imposed in lieu of revocation, the Service may still revoke a charity’s exemption when appropriate.⁹⁰

Under the intermediate sanctions regime, when a “disqualified person” benefits from an “excess benefit transaction” with an “applicable tax-exempt organization,” the disqualified person will be liable for an initial penalty of 25 percent of the excess benefit⁹¹—a relatively high excise tax for an initial infraction.⁹² A disqualified person is any person in a position

84. *Id.* See *Ginsberg v. Comm’r*, 46 T.C. 47 (1966). See also Rev. Rul. 70-186, 1970-1 C.B. 129.

85. I.R.S. Gen. Couns. Mem. 37,789 at 3–4 (Dec. 18, 1978).

86. The private inurement doctrine was viewed as a drastic and often inappropriate remedy, particularly where an organization was punished—through the loss of its exemption—for the wrongdoing of one particular individual. See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 252–53 (2009). Also, the uncertainty surrounding the scope of the private inurement doctrine created enforcement problems for the Service. FISHMAN & SCHWARZ, *supra* note 2, at 461.

87. Section 4958 is modeled after the omnibus private foundation reforms passed in 1969, although the sanctions and restrictions may be described as more lenient. See FREMONT-SMITH, *supra* note 86, at 253. See also FISHMAN & SCHWARZ, *supra* note 2, at 462.

88. FREMONT-SMITH, *supra* note 86, at 253.

89. *Id.* See FISHMAN & SCHWARZ, *supra* note 2, at 461 (describing testimony from IRS Commissioner Margaret Richardson to Congress in which she observed the disproportionality that can result from the revocation of an organization’s exemption where only minor or isolated instances of inurement have occurred). See also *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153–54 (E.D. Wash. 1963) (organization’s exemption was revoked because members received lunch and a snack).

90. FISHMAN & SCHWARZ, *supra* note 2, at 462.

91. I.R.C. § 4858 (2010).

92. The high penalty could be because these infractions are considered to be particularly egregious or because it’s unlikely the IRS will revoke the charity’s tax exemption. If not corrected in the taxable period (60 days), the tax goes up (200%). I.R.C. § 4958(b) (2010). The shortness of the

to exercise substantial influence over the affairs of the applicable tax-exempt organization within a five-year period ending on the date of the inappropriate transaction.⁹³ An “excess benefit transaction” is a transaction in which a tax-exempt organization provides an economic benefit directly or indirectly to or for the use of a disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.⁹⁴ An applicable tax-exempt organization is an organization exempt under section 501(c)(3) or 501(c)(4),⁹⁵ not including private foundations.⁹⁶

With “disqualified persons” rules, the Service was attempting to clarify exactly who is or is not an “insider.”⁹⁷ The classification scheme is comprehensive. Those classified as disqualified persons include: (1) “[v]oting members of the governing body;” (2) officers, such as presidents and chief executive officers, with the “ultimate responsibility for implementing the decisions of the governing body, or . . . supervising the management, administration, or operation of the organization;” and (3) officers, such as treasurers and chief financial officers, with the “ultimate responsibility for managing the finances of the organization.”⁹⁸ Close family members of disqualified persons are also included as disqualified persons.⁹⁹ Outside of the certain enumerated categories, the determination of whether a person is a disqualified person rests on a facts and circumstances test, with certain factors related to control and financial influence weighing into the calculation.¹⁰⁰

taxable period arguably coerces a disqualified person to pay the initial tax. Generally, a disqualified person may correct the excess benefit by returning the charity to the financial position it would have been in had the improper transaction or transactions not occurred. *See* FISHMAN & SCHWARZ, *supra* note 2, at 462–63. Managers who knowingly and willfully participate in an excess benefit transaction without reasonable cause may be liable for an excise tax equal to ten percent of the excise benefit. Treas. Reg. § 53.4958-1(a) (2002).

93. I.R.C. § 4958(f)(1) (2010); Treas. Reg. § 53.4958-3(a)(1) (2002).

94. I.R.C. § 4958(c)(1)(A) (2010); Treas. Reg. § 53.4958-4(a)(1) (2002).

95. Section 501(c)(4) exempts from taxation “[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.” I.R.C. § 501(c)(4)(A) (2010). These organizations are commonly referred to as “social welfare organizations.” Social welfare organizations are a popular corporate form for organizations that desire tax-exempt status and may have some sort of loosely defined charitable cause, but more often than not seek to engage in significant political or lobbying activities that would preclude them from securing 501(c)(3) status. For a discussion on section 501(c)(4) organizations, *see generally* FISHMAN & SCHWARZ, *supra* note 2, at 532–36.

96. Additionally, the Code includes a provision that covers any organization that would have been an applicable tax-exempt organization at any time during a five-year look back period ending on the date of the transaction. I.R.C. § 4958(e)(1)–(2) (2010).

97. Treas. Reg. § 53.4958-3 (2002).

98. Treas. Reg. § 53.4958-3(c) (2002).

99. Treas. Reg. § 53.4958-3(b) (2002).

100. Factors suggesting a person exercises substantial influence over an organization include

III. TWO CASE STUDIES

In this Part, I will analyze two cases demonstrating the application of and distinctions between the private inurement and private benefit doctrines. The first, *United Cancer Council v. Commissioner*,¹⁰¹ is a well-known Seventh Circuit opinion written by then Chief Judge Richard Posner. The second, *Capital Gymnastics Booster Club v. Commissioner*,¹⁰² is a recent Tax Court decision.

A. United Cancer Council v. Commissioner

*United Cancer Council v. Commissioner*¹⁰³ exemplifies the confusion that can result from the inconsistent application of the private inurement and private benefit doctrines. In 1984, the United Cancer Council (UCC) was a small, struggling charity¹⁰⁴ on the brink of bankruptcy. In an effort to raise the funds necessary for its survival, the UCC board entered into a contract with Watson & Hughey (W & H), a fundraising company. Because of UCC’s weak position, W & H negotiated very favorable contract terms, which included: (1) an exclusive five-year contract; (2) co-ownership of the prospective donor list generated by the fundraising campaign; and (3) restrictions on the UCC that prevented it from ever selling or leasing the prospective donor list generated by the fundraising campaign. In return, W & H agreed to fund the costs associated with the fundraising campaign.¹⁰⁵

The W & H campaign raised an astonishing amount of money—nearly \$29 million. However, \$26.5 million went to W & H to reimburse it for its fundraising expenses and presumably to compensate it.¹⁰⁶ Only \$2.3 million went directly to UCC’s charitable efforts.¹⁰⁷ When the contract

circumstances where the person: (1) “founded the organization;” (2) “is a substantial contributor” (more than \$5000 if such amount is more than two percent of the total contributions before the close of taxable year in which the donation is received); (3) receives compensation “primarily based on revenues” from the organization’s activities; (4) “has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees;” or (5) “manages a discrete segment or activity of the organization that represents a substantial portion of the [organization’s] activities, assets, income, or expenses.” Treas. Reg. § 53.4958-3(e)(2) (2002). Factors suggesting a person does not exercise substantial influence over an organization include circumstances where the person “does not participate in any management decisions affecting the organization.” Treas. Reg. § 53.4958-3(e)(3) (2002).

101. 165 F.3d 1173 (7th Cir. 1999).

102. T.C.M. (RIA) 2013-193.

103. 165 F.3d 1173 (7th Cir. 1999).

104. UCC’s annual operating budget was \$35,000. *Id.* at 1175.

105. *Id.*

106. *Id.*

107. UCC spent \$2.3 million “for services to cancer patients and on research for the prevention

with W & H expired in 1989, UCC did not renew it, but instead hired another fundraising company.¹⁰⁸ Within a year, UCC declared bankruptcy, and the Service retroactively revoked UCC's exemption to 1984 when UCC signed the contract with W & H.¹⁰⁹

The Service based its revocation on its belief that UCC had ceased to operate exclusively for charitable purposes and was instead operated for the private benefit of W & H.¹¹⁰ The Service also claimed that part of UCC's net earnings inured to the benefit of W & H.¹¹¹ The Tax Court upheld the Service's revocation purely on the grounds of private inurement and did not rule on the private benefit claim.¹¹²

The Service and the Tax Court argued that the particular terms and circumstances of UCC's contract with W & H were so favorable as to make W & H an "insider" of the charity, thus triggering the private inurement clause of I.R.C. § 501(c)(3).¹¹³ The Service's argument for private inurement as a result of the particular terms and circumstances of the contract applied the following logic. First, because UCC was nearly insolvent at the time of the contract and W & H provided the initial fundraising expenses, W & H acted like a founder or co-founder. Second, W & H was in effect the real beneficiary of the fundraising efforts because it received 90% of the contributions. Third, as a result of the exclusive contract, W & H seized control of UCC and UCC was therefore at the mercy of W & H. Fourth, UCC surrendered its rights to rent out the list of donors generated by W & H. Finally, the contractual terms were more favorable than the average fundraising contract.¹¹⁴

This was not the first time the Service denied or revoked exemption to a charity on the basis that the contractual terms between a fundraiser and a charity were so one-sided as to constitute both a private inurement and private benefit.¹¹⁵ In *Senior Citizens of Missouri, Inc. v. Commissioner*, the Service denied exemption to a charity that hired independent contractors to solicit funds for the charity through telephone solicitation.¹¹⁶ The charity paid the solicitors both advances (more than 33% of gross income) and

and treatment of cancer." *Id.* But because the fundraising letters distributed by W & H contained advice about preventing cancer—an educational activity—UCC was permitted to classify \$12.2 million of its fundraising expenses as charitable expenditures. *Id.*

108. *Id.*

109. *Id.* at 1176.

110. *Id.* at 1174–75.

111. *Id.* at 1175.

112. *Id.*

113. *Id.* at 1176.

114. *Id.*

115. See *Senior Citizens of Mo., Inc. v. Comm'r*, 56 T.C.M. (CCH) 480 (1988).

116. *Id.* at *1-3.

commissions (25% of gross income) such that the commissions and advances were equal to nearly 60% of the charity’s gross income.¹¹⁷ The charity used less than 10% of its gross income to further its exempt purposes.¹¹⁸

The Tax Court upheld the Service’s denial of the charity’s application for tax exemption, based solely on a private benefit analysis.¹¹⁹ Focusing purely on the advances paid to the solicitors,¹²⁰ the Tax Court found that the charity failed not only to establish that the advances were paid for services performed, but also to explain the criteria used for determining the amount paid in advances to each solicitor.¹²¹ Because the advances did not further an exempt purpose and were not insubstantial,¹²² the Tax Court held that the charity failed the operational test of I.R.C. § 501(c)(3).

Unlike in *Senior Citizens of Missouri, Inc.*, the Tax Court in *United Cancer Commission* relied exclusively on the private inurement doctrine and did not rule on the Service’s private benefit charges.¹²³ In the Seventh Circuit’s opinion, then-Chief Judge Posner seemed to imply that had the Tax Court ruled for the Service on the private benefit charge, he might have upheld it.¹²⁴ On the private inurement charge, however, Judge Posner reversed the Tax Court.¹²⁵ Regarding the Service’s five-point argument for inurement, Judge Posner stated, “these points bear no relation that we can see to the inurement provision.”¹²⁶

With respect to the Service’s first point—that because UCC was nearly insolvent at the time of the contract and W & H paid the fundraising

117. *Id.* at *2.

118. *Id.*

119. *Id.* at *3-5.

120. The administrative record focused purely on the advances. *Id.* at *3.

121. *Id.* at *4.

122. “Petitioner paid unexplained advances representing 33.2 percent of its gross revenues. We find this to be clearly substantial, especially when considering that petitioner spent only 8.9 percent of gross revenues on dinners, picnics and other activities for the elderly.” *Id.* at *5.

123. See *United Cancer Council, Inc. v. Commissioner*, 109 T.C. 326, 381–400 (1997).

124.

[T]he board of a charity has a duty of care, just like the board of an ordinary business corporation, and a violation of that duty which involved the dissipation of the charity’s assets might (we need not decide whether it would—we leave that issue to the Tax Court in the first instance) support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity. This, for all we know, may be such a case.

United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173, 1180 (7th Cir. 1999) (internal citations omitted).

125. *Id.* at 1179.

126. *Id.* at 1176. Judge Posner posits that the private inurement provision “is designed to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm’s length contracts made by charitable organizations with the firms that supply them with essential inputs, whether premises, paper, computers, legal advice, or fundraising services.” *Id.*

expenses, W & H acted like a founder or co-founder—Judge Posner argued that accepting the Service’s argument “would deny the charitable tax exemption to any new or small charity that wanted to grow by soliciting donations, since it would have to get the cash to pay for the solicitations from an outside source, logically a fundraising organization.”¹²⁷ While admitting that the Service’s second point—that because W & H received ninety percent of the contributions it was the real beneficiary—“ha[d] the most intuitive appeal,” Judge Posner reasoned that UCC received a charitable “bang” from the mailings due to their educational content.¹²⁸ Judge Posner also reasoned that such a comparison (gross expenses to net receipts) was like comparing “a ratio of apples to oranges” and because W & H’s total expenses were unknown, the high ratio of W & H’s expenses to UCC’s net charitable receipts was a difficult issue to determine without knowing the amount of W & H’s profit.¹²⁹

To the Service’s third point—that the exclusive contract gave W & H effective control of UCC—Judge Posner argued that there was “nothing that corporate or agency law would recognize as control.”¹³⁰ Furthermore, Judge Posner argued that “[i]f UCC had hired ten fundraisers, the Service couldn’t argue that any of them was so large a recipient of the charity’s expenditures that it must be deemed to have controlled the charity.”¹³¹ Moreover, Judge Posner noted that (1) the exclusive contract was meant to protect W&H’s investment;¹³² (2) W&H only funded UCC at the beginning;¹³³ (3) W & H had a contractual obligation to put forth its best

127. *Id.* at 1177.

128. *Id.* at 1177–78.

129. *Id.* at 1178. Judge Posner stated “[T]he ratio of expenses to net charitable receipts is unrelated to the issue of inurement.” *Id.* at 1178. This statement is at odds with the Tax Court, which considered the ratio of fundraising expenses to net charitable receipts in *Senior Citizens of Missouri, Inc. v. Commissioner*, 56 T.C.M. (CCH) 480 (1988). Also, it is at odds with the Ninth Circuit’s holding in *Church of Scientology of California v. Commissioner*, 823 F.2d 1310 (9th Cir. 1987), where the Court utilized a “cumulative effect” approach to considering whether Church payments on behalf of founder L. Ron Hubbard constituted inurement. The Court did not directly rule on whether salaries and living expenses paid to Hubbard and his family constituted inurement, but it held that “the cumulative effect of Hubbard’s use of the Church to promote royalty income, Hubbard’s unfettered control over millions of church assets, and his receipt of untold thousands of dollars worth of ‘debt repayments’ strongly demonstrate[d] inurement.” *Id.* at 1319. Thus, the law may not be as clear on this issue (that the ratio of expenses paid to a third party to the net charitable receipts of a charity is unrelated to the issue of inurement) as Judge Posner has written.

130. *United Cancer Council, Inc.*, 165 F.3d at 1178.

131. *Id.* at 1177.

132. *Id.* (“W & H obtained an exclusive contract . . . not because it sought to control UCC and suck it dry, but because it was taking a risk; the exclusive contract lent assurance that if the venture succeeded, UCC wouldn’t hire other fundraisers to reap where W & H had sown.”).

133. *Id.* (“[I]t was only at the beginning of the contract period that W & H was funding UCC. As donations poured into the charity’s coffers as a result of the success of the fundraising campaign, the charity began paying for the subsequent stages of the campaign out of its own revenues.”).

good-faith fundraising efforts;¹³⁴ and (4) the fact that W & H controlled an escrow account was “a detail.”¹³⁵

Regarding the Service’s final points—that UCC surrendered its rights to rent out the list of donors generated by W & H, and in sum, the terms were more favorable than the average fundraising contract—Judge Posner argued that the Service failed to understand the subtle differences in the value of a “housefile”¹³⁶ to a fundraiser and to a charity. Further, he noted that the simple reason for the markedly one-sided contract was that UCC was “desperate.”¹³⁷ Thus, Judge Posner reversed the Tax Court and remanded with instructions for the court to consider the Service’s private benefit basis for revoking UCC’s exemption.¹³⁸

The facts in *United Cancer Council* suggest that the charity was no longer operating for a public benefit. But by ruling only on the private inurement charge, the Tax Court handcuffed Judge Posner. His application of the private inurement doctrine is correct. The doctrine is limited to “insiders.” Accordingly, no matter how one-sided the contract between UCC and W & H was, it likely did not make W & H “insiders” for at least three reasons. First, there was no prior relationship between the two entities. Second, the contract was negotiated at arm’s length. Third, the favorable terms of the contract were the result of UCC being flat on its back and in a comprised position from a bargaining standpoint.

However, it would be useful for our purposes in this Note to apply the private benefit doctrine to the facts of *United Cancer Council*. Whether UCC passes the private benefit test likely turns on how the \$12.2 million of fundraising expenses the charity classified as educational expenditures are treated. Without examining the letters to deem the value of the educational materials, it is difficult to know for certain, but, it is fairly clear that the primary purpose of the letters was fundraising. Therefore, the value of the charitable benefit is questionable. If the \$12.2 million is

134. *Id.* (“When a firm is granted an exclusive contract, the law reads into it an obligation that the firm use its best efforts to promote the contract’s objectives.”).

135. *Id.* (“[T]his is a detail; the important point is that UCC did not receive repeated infusions of capital from W & H.”).

136.

The housefile’s value to a charity is . . . a list of people who are good prospects to respond favorably to future solicitations. Its value to the fundraiser is quite different. The fundraiser is not a charity. The value to it of a housefile that it has created is the possibility of marketing it (as a prospect file—but as a prospect file in which all the prospects are charitable donors rather than a mere cross-section of potential donors) to another charity that hires it.

Id.

137. *Id.* at 1178.

138. *Id.* at 1179–80. Before the Tax Court could reconsider the case, the two parties settled. *See* Errol Copilevitz, *Looking Back to Assess the United Cancer Council Case*, 13 JTXEO 63, *66 (2001).

excluded, the proportion of donated funds dedicated to furthering UCC's exempt purposes is less than 10%, with more than 90% of the donated funds going to W & H. From a quantitative standpoint, this likely fails the private benefit test. The facts in *United Cancer Council* are analogous to those of IRS Revenue Ruling 76-152,¹³⁹ where the Service ruled that an art gallery that turned over 90% of all its sales proceeds was not operated exclusively for an exempt purpose.¹⁴⁰ More than 90% of UCC's donated funds went to W & H. Whether those funds went to defraying W & H's costs or not, with less than 10% of UCC's raised funds going directly towards pursuing its charitable purposes, it was likely no longer being operated exclusively for charitable purposes. Yet, without being able to examine the fundraising letters and evaluate their educational content, it is difficult to make a definitive determination.

139. Rev. Rul. 76-152, 1976-1 C.B. 152.

140.

[T]he artists in the subject case are being directly benefited by the exhibition and sale of their works, with the result that a major activity of the organization is serving the private interests of those artists whose works are displayed for sale. Since ninety percent of all sales proceeds are turned over to the individual artists, such direct benefits are substantial by any measure and the organization's provision of them cannot be dismissed as being merely incidental to its other purposes and activities.

Id. at *2.

B. Capital Gymnastics Booster Club v. Commissioner

While wafts of impropriety abound *United Cancer Council*, the initial odor of the facts in *Capital Gymnastics Booster Club v. Commissioner*¹⁴¹ is not particularly unpleasant. Capital Gymnastics Booster Club was a small charity formed to provide financial support to young athletes (fostering sports competition under I.R.C. § 501(c)(3)) who participated on teams at a local private gym.¹⁴² Capital Gymnastics collected annual assessments from the parents of the young athletes.¹⁴³ These assessments were used to cover entry fees for meets and to offset travel expenditures for the coaches of the gymnastics teams.¹⁴⁴ The fees ranged from \$600 to \$1400 per athlete depending on skill level.¹⁴⁵

Families could satisfy the annual assessment either by paying cash or by participating in a fundraising program that awarded “points” towards the annual assessment.¹⁴⁶ The amount raised was credited against the athlete’s assessment. Approximately 46% of the families participated in the fundraising program in 2003, and the fundraising generated a net profit of \$35,326.¹⁴⁷ Capital Gymnastics used 93% of the profit to reduce the annual assessments, on average, by 50 to 70% for the families who fundraised. It did not credit any of the profit against the assessments of athletes whose families did not fundraise. The Service revoked Capital Gymnastics’ exemption, claiming that the charity “had failed to establish that its income ‘did not inure to the benefit of private individuals and shareholders, which is prohibited by I.R.C. § 501(c)(3).’”¹⁴⁸

Capital Gymnastics, conceding that the parents were “insiders,” claimed that its method of fundraising did not violate the private inurement prohibition because the charity “‘never pa[id] money to any of its members’ and instead spen[t] its funds ‘exclusively on competition-related expenses of the athletes.’”¹⁴⁹ Capital Gymnastics argued that the “‘true recipient of its generosity was not the parents but instead ‘a well-defined charitable class’ of ‘school age children competing on the Training Center’s amateur gymnastics and power tumbling teams.’”¹⁵⁰ This was a

141. T.C.M. (RIA) 2013-193.

142. *Id.* at 3–4.

143. *Id.* at 5–6.

144. *Id.* at 6.

145. *Id.* at 5.

146. *Id.* at 6–9.

147. *Id.* at 9.

148. *Id.* at 11.

149. *Id.* at 17. Capital Gymnastics further argued that its “‘unequal sharing of fundraising profits’” did not constitute private inurement because it was not a “‘constructive distribution.’” *Id.*

150. *Id.* at 17–18.

savvy argument, if not a successful one. Although Capital Gymnastics argued that parents fundraised because they “needed the money,” the club failed to offer any supporting evidence.¹⁵¹ Capital Gymnastics argued it was “‘inconceivable that Congress could have intended such an absurd result’ as to prohibit booster clubs from spending any part of their earnings for the benefit of the children who are on an athletic team.”¹⁵²

The Service conceded that Capital Gymnastics, as a charity dedicated to fostering amateur sports competition, passed the organizational test for exemption.¹⁵³ The Service also conceded that Capital Gymnastics’ amateur athletes were “members of a charitable class.”¹⁵⁴ But the Service objected to the fact “that ‘almost all of petitioner’s fundraised proceeds are earmarked to benefit those individuals who fundraised.’”¹⁵⁵ Therefore, the Service argued that the arrangement violated the private inurement and private benefit doctrines “because the methodology further[ed] private interests rather than the team or the organization as a whole.”¹⁵⁶

The Tax Court held that Capital Gymnastics’ fundraising arrangement allowed “substantial private inurement” to the parents who fundraised and therefore conferred an “impermissible substantial private benefit” on the young athletes of only those parents.¹⁵⁷ Further, the Tax Court stressed that rather than benefiting all the young athletes in its programs, the fundraising program benefited only the children of parents who fundraised.¹⁵⁸ In reaching its decision, the Tax Court considered the following facts and circumstances. First, unlike “a school band’s sale of candy or a church youth group’s carwash for a once-a-year event,” the fundraising was the primary function of the organization.¹⁵⁹ Second, the assessments were not optional nor were scholarships made available to those unable to pay.¹⁶⁰ Third, the fundraising was optional as opposed to mandated.¹⁶¹ And, fourth, the assessments were large obligations—not the type of “de minimis charges that might be covered by a child’s paper route or babysitting.”¹⁶²

The Tax Court continued its analysis by examining Capital

151. *Id.* at 18.

152. *Id.*

153. *Id.* at 19.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.* at 19–20.

158. *Id.* at 20.

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

Gymnastics’ fundraising method, which it determined was unacceptable because the financial benefits of the charity were focused directly on, and self-selected, by the members.¹⁶³ Furthermore, “Capital Gymnastics made no showing that the parent-members who received its fundraising ‘points’ (i.e., the parents who did fundraising) were actually poor, disadvantaged, in financial distress, or otherwise members of any charitable class.”¹⁶⁴ Finally, the Tax Court held that the “‘points’ were as good as dollars”¹⁶⁵ and that “[t]he benefit that Capital Gymnastics conferred on fundraising families was hardly insubstantial.”¹⁶⁶

Capital Gymnastics presents an interesting question concerning the application of the private benefit doctrine. Were the parent’s fundraising activities “incidental” to its stated primary purpose: fostering amateur athletics, a statutorily recognized public benefit? The Tax Court held that fundraising was the primary purpose of the organization. Yet the determination of whether a benefit is substantial or insubstantial is an unsettled area of the private benefit doctrine.¹⁶⁷

I argue that the private benefit analysis in the *Capital Gymnastics* is essentially moot, however, because it is difficult to argue that the private inurement prohibition was not violated. It is not contested that the parents were insiders. Putting aside the charitable class arguments presented in the case (and conceding that the parents, and not the children, were the true beneficiaries), it could be argued that the parents received income through the discharge of a financial obligation they incurred once their children participated in the team’s gymnastics activities.¹⁶⁸ It also could be argued that under the Haig-Simons economic definition of income,¹⁶⁹ the parents received income based on the consumption of gymnastics activities by their children. Whether the market cost of the gymnastics activities was paid in cash by the parents or discharged in the form of points, the parents consumed the activities on behalf of their children and therefore realized income. Thus, as insiders, the parents were in violation of the private

163. *Id.* at 21–22.

164. *Id.* at 23.

165. *Id.* at 23.

166. *Id.* at 24 (“Capital Gymnastics’ figures are substantial both in absolute terms and in relative terms. By comparison, in *Wendy L. Parker Rehab. Found., Inc.*, a smaller amount of inurement—i.e., 30% of that foundation’s \$7,500 in income—was still large enough to constitute substantial inurement.”).

167. *See supra* Part II.B.

168. *See Old Colony Trust Co. v. Comm’r*, 279 U.S. 716 (1929).

169. The Haig-Simons economic definition of income defines income “as the sum of the taxpayer’s consumption plus change in net worth, each defined in terms of market value during some specified accounting period (such as a taxable year).” *See* JOSEPH BANKMAN, DANIEL N. SHAVIRO, & KIRK J. STARK, *FEDERAL INCOME TAXATION* 13 (16th ed. 2012).

inurement doctrine.

But was the revocation of Capital Gymnastics' tax-exempt status a just result? It is difficult to reconcile the respective outcomes of *United Cancer Council* and *Capital Gymnastics*. In *United Cancer Council*, UCC was found to have not violated the private inurement doctrine because W & H was not an insider. The Tax Court did not rule on the private benefit claim, so Judge Posner could not consider it. Thus, some might argue—fairly—that UCC kept its tax-exempt status because of technicalities.

Contrast *Capital Gymnastics*, where some might argue—also fairly—that Capital Gymnastics lost its tax-exempt status because of technicalities. If all the parents had fundraised and all the parents had received a discount on their dues, it is unlikely there would have been any question about the booster club's tax-exempt status. But because only the parents who fundraised received a financial benefit not afforded to the general public, Capital Gymnastics' tax-exempt status was revoked.

The results in *United Cancer Council* and *Capital Gymnastics* are legally sound. The private inurement and private benefit doctrines were correctly applied. Yet the results are not morally intuitive, and this begs the question why. Perhaps a consolidated, simplified doctrine could apply the letter of the law without imposing drastic, draconian sanctions on those who are still promoting an underlying charitable good.

IV. CONSOLIDATING THE PERPLEXITIES OF THE PRIVATE INUREMENT AND PRIVATE BENEFIT DOCTRINES

There are several arguments for consolidating the private inurement and private benefit doctrines into one cohesive doctrine. First, the private inurement doctrine is murky and subject to inconsistent application. Second, the private inurement doctrine is redundant, because it has largely been supplanted by the intermediate sanctions regime and may be subsumed within the private benefit doctrine. Third, a consolidation of the two doctrines will result in judicial economy. I will discuss these arguments in order.

My first argument for consolidating the private inurement and private benefit doctrines is that the private inurement doctrine is murky and inconsistently applied. Conventional wisdom dictates that the private inurement and private benefit doctrines differ in two respects. First, an incidental amount of private benefit is not fatal to an organization's exemption, whereas even the slightest amount of private inurement may lead to revocation of an organization's exemption. Second, the private

inurement doctrine applies only to “insiders,” whereas the private benefit doctrine may be applied to non-insider persons.¹⁷⁰

However, neither the absolute prohibition, nor the insider distinction is clear in practice. For example, although the statutory proscription against private inurement is complete, courts have considered the amount of private inurement in determining whether to revoke a charity’s exemption.¹⁷¹ It is not clear whether this means a court might accept an incidental amount of private inurement in certain circumstances. In fact, some courts have held that any amount of inurement is prohibited.¹⁷² And it would not be unprecedented for the literal language of the Internal Revenue Code to mean something else in practical application. To cite but one example, the literal language of section 501(c)(3) states that an organization must be organized and operated “exclusively” for charitable purposes; however, the Treasury Regulations clarify that “exclusively” means “primarily.”¹⁷³ Similarly, the technical language of the private inurement doctrine applies only to insiders, but exactly who may qualify as an insider is unclear because the test looks to “reality of control.”¹⁷⁴ Professor Darryll Jones has written that such uncertainty surrounding the private inurement doctrine has led it to be “applied in vague, non-literal, and inconsistent ways.”¹⁷⁵ And Professor Henry Hansmann has argued that the “vagueness of the statutory language” may in fact have resulted in limited policing efforts by the Service.¹⁷⁶ The lack of clarity regarding whether the proscription is indeed absolute—or is subject to some leniency—and the lack of clarity regarding whom qualifies as an insider (as evidenced in the *United Cancer Council* case) result in a private inurement doctrine that is nebulous and confused. This confusion could be resolved by subsuming the private inurement doctrine within the private benefit doctrine, which considers qualitative and quantitative factors rather than an absolute prohibition and includes no insider requirement.

My second argument for the consolidation of the private inurement and private benefit doctrines is to remove two redundancies. First, the passage of I.R.C. § 4958 and the intermediate sanctions regime has given the

170. See FREMONT-SMITH, *supra* note 86, at 250–51. See also HOPKINS, *supra* note 30, at 537.

171. See *Church of Scientology of Cal. v. Comm’r*, 823 F.2d 1310, 1315–16 (9th Cir. 1987).

172. *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153 (E.D. Wash. 1963).

173. Contrast the language of I.R.C. § 501(c)(3) with that in Treas. Reg. § 1.501(c)(3)-1(c)(1), which states, “An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).” Treas. Reg. § 1.501(c)(3)-1(c)(1) (2012).

174. *United Cancer Council v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

175. Jones, *supra* note 57, at 580 n.16 (surveying the literature and concluding that the private inurement doctrine “is applied in vague, non-literal, and inconsistent ways”).

176. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 15, at 603.

Service a more effective policing tool for dealing with “insiders” that has largely supplanted the private inurement doctrine and rendered it a redundant and cumbersome alternative.¹⁷⁷ As a result, the vagueness of the private inurement doctrine has been replaced with a regime that features clear, extensive definitions and penalties that can be enforced directly on bad actors without revoking the organization’s exemption absent warranted circumstances.

In addition, courts have opined on the redundancies of the private inurement doctrine. Their arguments generally turn on the fact that the private inurement doctrine may be subsumed within the private benefit doctrine.¹⁷⁸ Despite the private benefit doctrine’s roots in the common law, both doctrines flow directly from the statute, which requires a charity to be organized and operated exclusively for an exempt purpose.¹⁷⁹ While the private inurement doctrine is explicitly spelled out, the private benefit prohibition may be read into the statute and “is but another way of requiring that an organization be operated exclusively for tax-exempt purposes, i.e., for public benefit.”¹⁸⁰ Similarly, if a charity is in violation of the private inurement doctrine by operating for the direct benefit of an insider, such as the creator of the charity or members of the creator’s family, the charity is then also not operating exclusively for an exempt purpose.¹⁸¹ Furthermore, a close examination of the Treasury Regulations thought to create the modern private benefit doctrine¹⁸² reveals a section that appears very similar to the “insider” requirements of the private inurement doctrine.¹⁸³ Thus, if an organization is violating the private

177. See Colombo, *supra* note 70, at 1068 (“Today, the private inurement limitation largely has been supplanted by I.R.C. § 4958 (what was once known as the ‘intermediate sanctions’ legislation), which provides statutory remedies short of loss of tax exemption for these siphoning transactions.”). See also FISHMAN & SCHWARZ, *supra* note 2, at 445–46 (“Congress gave the Service a new and more effective weapon in 1996 when it enacted the § 4958 intermediate sanctions regime.”).

178. See *W. Catholic Church v. Comm’r*, 73 T.C. 196, 209 n.27 (1979) (“The prohibition against private inurement of net earnings appears redundant, since such a benefit would be inconsistent with operating exclusively for an exempt purpose.”). See also *Unitary Mission Church of Long Island v. Comm’r*, 74 T.C. 507, 512 n.7 (1980) (“We have previously commented that the separately stated private inurement prohibition is redundant to the requirement that an organization be operated exclusively for one or more exempt purpose since operating exclusively for an exempt purpose necessitates providing a public, and not private, benefit.”).

179. I.R.C. § 501(c)(3) (2010).

180. *Western Catholic Church*, 73 T.C. at 213. See also *Alive Fellowship of Harmonious Living v. Comm’r*, 47 T.C.M. (CCH) 1134 (1984).

181. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1065 (1989) (“When an organization operates for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests, the organization by definition does not operate exclusively for exempt purposes.”).

182. See *Treas. Reg.* § 1.501(c)(3)-1(d)(1)(ii) (2012).

183.

On first glance, the language in [*Treas. Reg.* § 1.501(c)(3)-1(d)(1)(ii)] would seem to be little

inurement doctrine, it is necessarily violating the private benefit doctrine.¹⁸⁴ Although the reverse is not true,¹⁸⁵ the private inurement doctrine is therefore redundant and may be subsumed within the private benefit doctrine.¹⁸⁶

My final argument for consolidating the private inurement and private benefit doctrines is that such a consolidation will result in judicial economy. As evidenced in the *United Cancer Council* case, if a lower court bases its decision solely on a private inurement analysis, it can foreclose an appellate judge from considering a private benefit analysis, thus causing major inefficiency.¹⁸⁷ Because both prohibitions require consideration of similar facts and circumstances, courts have expressed a preference for considering and discussing the doctrines together.¹⁸⁸ The

more than an augmented explanation of the statutory private inurement limitation. For example, when the regulation states that an exempt charity must not be ‘organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests,’ it appears that the regulation is discussing mostly *insiders* of the organization: the creator, shareholders, or parties controlled by them. Indeed, the classic *ejusdem generis* maxim of statutory interpretation would call for the general term in this regulation (“private interests”) to be limited by the expression of the specific examples, which are *designated individuals, the creator and shareholders*, all words that seem to convey an insider relationship with the entity. Perhaps because Treasury Regulation § 1.501(c)(3)-1(c)(1) refers more explicitly to inurement, however, the IRS over the past thirty years has viewed the private benefit language as a separate limitation on exempt status.

Colombo, *supra* note 70, at 1068–69.

184.

[W]e have often observed that the prohibition against private inurement of net earnings appears redundant, since the inurement of earnings to an interested person or insider would constitute the conferral of a benefit inconsistent with operating exclusively for an exempt purpose. In other words, when an organization permits its net earnings to inure to the benefit of a private shareholder or individual, it transgresses the private inurement prohibition and operates for a nonexempt private purpose.

Am. Campaign Acad., 92 T.C. at 1068 (internal citations omitted).

185. Because the private benefit doctrine applies to non-insider persons, it may not be subsumed within the private inurement doctrine. Colombo, *supra* note 70, at 1068–69. But, it is hard to see the benefit in trying to subsume private benefit within private inurement, because private benefit is broader and can sanction a wider array of non-exempt behavior.

186. *Id.*

187.

It would have been better had the court resolved that ground [private benefit] as well as the inurement ground, so that the case could be definitively resolved in one appeal. But it did not, and so the case must be remanded to enable the court to consider it. We shall not prejudge the proceedings on remand.

United Cancer Council v. Comm’r, 165 F.3d 1173, 1179 (7th Cir. 1999).

188.

Although the requirement that an organization be operated exclusively for tax-exempt purposes (and not for a private benefit) is statutorily distinct from the prohibition against the inurement of net earnings to the benefit of private individuals, for convenience, both requirements will be discussed together because much of the evidence is applicable to both.

doctrines overlap: violation of either results in the furtherance of a non-exempt purpose; both doctrines ensure the furtherance of a public and not a private interest; and private benefit subsumes private inurement.¹⁸⁹ Therefore, an approach that considers both doctrines together maximizes judicial economy. A consolidated doctrine will prevent situations like *United Cancer Council*, where the lower court fails to rule on one ground or the other.

Moreover, at the nexus of the enterprise of judging lies fidelity to law.¹⁹⁰ And, fundamental to fidelity to law is the precept that “like cases ought to be decided alike.”¹⁹¹ Subsuming the private inurement doctrine within the private benefit doctrine will establish a clear, yet broad foundation upon which judges can cautiously build within the boundaries of the larger legal system. All in all, there is one essential question that must be answered, regardless of whether someone is an insider: “is this charity exclusively serving a charitable purpose that merits continued tax exemption?” With this core principle in mind and a simplified scheme, judges stand a better chance of “deciding like cases alike” and achieving fidelity to law.

CONCLUSION

Much time and energy has been spent describing the differences between the private inurement and private benefit doctrines. It is fair to ask whether this time and energy may have been better spent consolidating

W. *Catholic Church v. Comm’r*, 73 T.C. 196, 213 (1979).

189.

If the organization engages in either inurement or private benefit, then the organization is furthering a non-exempt purpose. The prohibition against inurement, like the prohibition of private benefit, ensures that the exempt organization is serving a public and not a private interest, and the two prohibitions thus have a common purpose. And because ‘private benefit’ encompasses but is broader in scope than ‘inurement’, they overlap.

Capital Gymnastics Booster Club, Inc. v. Comm’r, T.C.M. (RIA) 2013-193, *6 (internal citations omitted).

190. Russell K. Osgood, *The Enterprise of Judging*, 17 HARV. J.L. & PUB. POL’Y 13, 14–15 (1994).

191. *Id.* at 14.

Fidelity to law is the core of the enterprise of judging, and consists of several elements. First, like cases ought to be decided alike. The argument for this is not just reliance, for frequently there is no real argument from reliance. The real rationale is that judicial commitment to the consistent application of rules and principles should be recognized as an end in itself. Second, judges should be loyal to the legal system as a semi-autonomous aspect of state power in a way that maximizes systemic harmony. Thus, judges should not just look in the immediate zone of a particular rule, statute, or prior decision, but across the entire legal system to resolve ambiguities and answer hard questions.

Id. (internal citations omitted).

these two closely related doctrines into one cohesive whole. Is there really a material difference between them? This Note suggests that there is not. They are effectively coterminous, with the exception of the insider question. Therefore, I argue for a unified doctrine that subsumes the private inurement doctrine within the private benefit doctrine with the caveat that insiders—which could be explicitly defined by Treasury Regulations—will be held to a higher standard than non-insider persons.

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